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OGC 73-1335

17 July 1973

MEMORANDUM FOR: Chief, Audit Staff

SUBJECT: Taxability of Cost of Living and Housing Allowances of Employees Stationed in the United States

1. You have asked whether cost of living allowances and housing allowances paid to employees stationed in the continental United States should be reported as gross income on the W-2 forms of such employees. The particular allowances giving rise to the question at this time are those paid to [redacted] employees 25X1A
of [redacted] Division, who are required by the Division to live within a 25X1A
small area of [redacted] 25X1A

2. In our opinion, cost of living allowances paid to employees stationed anywhere in the United States in order to compensate them for the difference in cost of living between Washington, D.C. and the area where stationed, are taxable compensation and should be reported on the W-2. Similarly, housing allowances to compensate for the difference between the cost of housing in the Washington, D.C. area and in the area where stationed, are taxable and reportable. However, in special situations, and specifically here, in the cases of employees directed and required to live in a particular section of a metropolitan area where they are stationed, a portion of a housing allowance need not be considered taxable compensation. The non-taxable portion is that which compensates for the difference between housing costs in those parts of a metropolitan area where employees would normally live and the higher cost where they are required to live.

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3. Section 61 of the Internal Revenue Code defines gross income as all income from whatever source derived. Treasury Regulation § 1.61-1 provides:

> Gross income means all income from whatever source derived, unless excluded by law. Gross income includes income realized in any form, whether in money, property, or services. Income may be realized, therefore, in the form of services, meals, accommodations, stock, or other property, as well as in cash.

Accordingly, if cost of living allowances and housing allowances are to be tax free, they must be excluded from income by the Code or Regulations, or they must be deductible as reimbursed expenses. Certain cost of living allowances and housing allowances, including housing in kind provided to Government employees serving abroad, are not taxable compensation because they are specifically exempted by § 912 of the Internal Revenue Code. There is no such statutory provision for housing or cost of living allowances paid to employees stationed in the United States.

4. Meals or lodging furnished for the convenience of the employer are excluded from gross income when certain conditions are met. Internal Revenue Code § 119 provides:

> There shall be excluded from gross income of an employee the value of any meals or lodging furnished to him by his employer for the convenience of the employer, but only if—
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> * * * * * * *
>
> (2) in the case of lodging, the employee is required to accept such lodging on the business premises of his employer as a condition of his employment.

Regulation § 1.119-1(b) provides:

> The value of lodging furnished to an employee by the employer shall be excluded from the employee's gross income if three tests are met:
>
> (1) The lodging is furnished on the business premises of the employer,
> (2) The lodging is furnished for the convenience of the employer, and
> (3) The employee is required to accept such lodging as a condition of his employment.
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> * * * * * * *
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> If the tests described in subparagraphs (1), (2) and (3) of this paragraph are met, the exclusion shall apply irrespective of whether a charge is made, or whether, under an employment contract or statute fixing the terms of employment, such lodging is furnished as compensation. . . . If the tests described in subparagraphs (1), (2) and (3) of this paragraph are not met, the employee shall include in gross income the value of the lodging regardless of whether it exceeds or is less than the amount charged. In the absence of evidence to the contrary, the value of the lodging may be deemed to be equal to the amount charged.

25X1A

In the case of the [redacted] employees, and probably in most other cases of employees receiving housing allowances in the United States, the condition of the Code that the lodging be on the business premises of the employer cannot be met. In addition, Regulation § 1.119-1(c)(2) provides:

> The exclusion provided by section 119 applies only to meals and lodging furnished in kind by an employer to his employee. If the employee has an option to receive additional compensation in lieu of meals or lodging in kind, the value of such meals and lodging is not excluded from gross income.

5. IRS and the courts have interpreted the "on the premises" requirement strictly.

> Thus, the rental value of a house and the value of food furnished by taxpayer's employer at an employer-owned residence located 'two short blocks' from the motel which taxpayer managed for the employer were includable in taxpayer's income.
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> C.N. Anderson, (CA-6) 67-1 USTC Para. 9136, 371 F.2d 59. Cert. denied, 387 U.S. 906.

> Supervisory employees of a woolen mill who lived rent-free in houses located about one mile from the mill in order that they might be on call 24 hours a day realized additional income in the amount of the fair rental value of the houses. The employees were not required to accept the lodging as a condition of their employment, and, moreover, the lodging was not on the employer's business premises.
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> G.S. Dole, 43 TC 697, Dec. 27, 253 (Acq.). Aff'd per curiam, (CA-1) 65-2 USTC Para. 9688, 351 F.2d 308.

25X1A The Code, Regulations and court decisions provide no basis for excluding the [redacted] housing allowance from taxable income. While the special circumstances here may provide a reasonable equitable argument, I do not believe the argument would prevail, and consequently, I would recommend against seeking a Revenue Ruling which almost certainly would be unfavorable.

6. In the case of the [redacted] housing 25X1A allowance, I think the circumstances causing the Agency to grant the allowance provide a legitimate means for effectively excluding at least part of it from each employee's income. The reason the allowance is given is that the employees must live in a particular small area [redacted] in order 25X1A to carry out their Agency duties. It is a requirement of the job, imposed by the Agency, that they live in this area. Internal Revenue Code § 162 provides that there shall be allowed as a deduction all the

ordinary and necessary expenses paid or incurred in carrying on any trade or business. The definition of business includes services as an employee so that any expenses incurred by an employee may be deducted if they meet the requirements. The law specifically includes as deductible expenses rentals, to the extent that they are incurred in carrying on a trade or business. In order to be deductible, an expense must meet three requirements: (1) it must be incurred in a trade or business carried on by the taxpayer, this excludes all personal expenses; (2) it cannot be a capital expenditure; and, (3) it must be ordinary and necessary. Housing is normally a personal expense, and obviously these [redacted] employees 25X1A
would incur personal housing expenses wherever they lived. Being
25X1A assigned to [redacted] they would live somewhere in the metropolitan area, and no part of their housing costs could be considered business expenses. However, in order to carry out their Agency duties, some of these employees are directed and required to live in a small area of the city where rents are very high and where, presumably, they would not ordinarily live. Accordingly, we are of the opinion that it would be reasonable and proper to consider the difference between the normal housing costs incurred by employees living where they
25X1A wish in the [redacted] area and the costs incurred by these employees required to live in a particular area as a reimbursed expense and thus deductible by the employee on his income tax return.

7. Security considerations will not permit these employees to report the business expense portion of the housing allowance as income and then take a deduction against it. However, IRS Regulations do not require reimbursements for ordinary and necessary business expenses to be included on the tax return if (1) the employee makes an accounting for such expenses to his employer; (2) he does not deduct his expenses on his return; and, (3) the expenses equal the reimbursement. The conditions under which these allowances are granted are substantially equivalent to the accounting requirement in (1) above and, therefore, it will not be necessary for the Agency to include the expense portion of the allowance on the employee's W-2, nor for the employee to report 25X1A
the income and take the deduction.

[redacted]

Assistant General Counsel

cc: SSA/DDM&S
C/FR Division
25X1A OGC [redacted] cap
Approved For Release 2004/11/01 : CIA-RDP75-00793R000300060021-8 TAXES 25X1A
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